UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK
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TEAMSTERS LOCAL445 FREIGHT
DIVISION PENSION FUND,

Plaintiff,

v. 05 Civ. 1897 (HB)

DYNEX CAPITAL INC., et al.,

Argument

Defendants.

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New York, N.Y.
September 14, 2011
9:40 a.m.

Before:

HON. HAROLD BAER, JR.

District Judge

APPEARANCES

COHEN MILSTEIN SELLERS & TOLL PLLC
Attorneys for Plaintiffs
BY: JOEL P. LAITMAN

HUNTON & WILLIAMS LLP
Attorneys for Defendant Dynex Capital Inc.
BY: JOSEPH SALTARELLI
EDWARD J. FUHR

(Case called)

THE COURT: We have a three-year case analysis in this courthouse, the concept being that you are supposed to be at zero in terms of your three-year-old cases. You are my only candidate. I just thought I'd let you in on it. In case anybody asks you how quickly you get rid of your cases, you can tell them not quick enough.

This is defendant's motion for summary judgment. That does not mean I'm going to get rid of it on summary judgment, however. Don't feel obliged on that score. But I will hear from the defendant first, since it is the defendant's motion.

MR. SALTARELLI: Good morning, your Honor. Joseph Saltarelli of Hunton & Williams on behalf of the defendant in support of the motion. With me at counsel table is Ed Fuhr.

Your Honor, if I may, I'm going to be addressing three of the six elements on the 10b-5 claim.

THE COURT: I'd be glad to do it any way you want, but I'm only interested in the market condition problem and the modification problem and something about underwriting statements. I really am not interested in the others. If you want to talk about them, you may, but there isn't really any interest on my part.

MR. SALTARELLI: Certainly, your Honor. If I may, I have prepared a short handout. It covers some of the documents that have been submitted to you. There is nothing new here. I

think it would be for the convenience of the Court, a little bit easier.

THE COURT: Fine.

MR. SALTARELLI: If I may hand up some for your law clerk as well.

THE COURT: The emphasis is on there is nothing new here, right?

MR. SALTARELLI: Yes, your Honor. There are two charts in there that I have drawn on the documents submitted, and the others are just enlarged documents that have been submitted in part of the motion.

Your Honor, you asked me to address some of the alleged misrepresentations. The underwriting statements I believe is the first one you mentioned.

THE COURT: Correct.

MR. SALTARELLI: Your Honor, the underwriting statements in Dynex II, I think your ruling was very clear that the underwriting statements could be actionable. There are two issues involved here. One is those statements were made in 1999 in the prospectuses. As we have cited in our brief, and they don't challenge it in their opposition, those statements are not actionable, because they fall outside of the class period. They were made in 1999 and the class period starts in 2000.

THE COURT: Now that we are talking about dates --

well, never mind. Go ahead. I'm going to try not to interrupt you.

MR. SALTARELLI: The underwriting statements, your Honor, are those statements that plaintiff alleges were made in the offering documents which were issued in 1999 that essentially said creditworthiness is the main characteristic of the borrowers on the loans.

In Dynex II you ruled quite clearly that the only way those type of statements could be actionable is if there was evidence of routine, blatant disregard by Dynex Financial of its own underwriting guidelines. There is no evidence of that, your Honor. They have presented none. In fact, when you go through their opposition brief, it is fairly clear that they have pretty much abandoned this claim, because there is no evidence supporting it.

THE COURT: Going back to your first prong, let's assume that the underwriting statements were drafted prior to the start of the class period. Don't you nonetheless have an ongoing duty to disclose material facts where those facts render the statements misleading?

MR. SALTARELLI: Your Honor, I think that's the ruling in an omissions case. You have a duty to disclose facts. If you don't disclose them and it keeps the prior statements misleading, you have a duty to disclose a fact if it is necessary to make a prior statement not misleading.

As I understand your ruling in Dynex II, you sustained those allegations from 1999, statements made in 1999, on the premise that continuing statements of a similar nature were made beyond 1999 and into the class period. But that is not the case. There is no evidence in the case that statements about the creditworthiness of the borrowers were made during the class period.

Those statements appeared in the offering documents which were issued in 1999. That is the premise for our first prong of that argument, which is the Lattanzio case in the Second Circuit, which says statements that are prior to the class period are not actionable. And since there is no spillover, for want of a better term, those statements would not be actionable.

Secondarily, on a purely evidentiary basis, your Honor, you ruled that those statements would be actionable not on the basis of the C-rated loan evidence, which is on virtually every page of their brief, but only if there was evidence of routine, blatant disregard of our underwriting guidelines and standards. There is no evidence of that, and they don't argue that there is.

So, those statements, your Honor, to the extent you said they were actionable in Dynex II, summary judgment should be granted on those statements.

THE COURT: I'm not sure we are on the same

wavelength. Like I said, I'm going to try and control myself. Keep going.

MR. SALTARELLI: Your Honor, that is how you define underwriting savings in Dynex II, so that is how we addressed it. I believe that responds to your point.

THE COURT: My only concern is that it seems to me there is a continuing obligation which I didn't get the impression you were so clear about. You have a continuing obligation to let your investors in on what is going on, and that was so even if the underwriting statements, as I said, were drafted before the class period began.

MR. SALTARELLI: Right, your Honor. But my point is any continuing duty into the class period must be connected to a falsity. In other words, were the underwriting statements false.

THE COURT: I understand.

MR. SALTARELLI: Therefore, there is a continuing duty, or a duty actually, to correct it.

THE COURT: We may disagree as to that aspect, the falsity concept.

MR. SALTARELLI: All I'm saying, your Honor, is in Dynex II you said that's how you can prove the falsity of those statements.

THE COURT: I got it.

MR. SALTARELLI: It is linked to the next thing that

I'm going to discuss, which is the loan rating system that they have talked about, the C-rated loans. You made two rulings in Dynex II. One was you can't prove the falsity of the underwriting statements just by referring to the predominance of C-rated loans within the bond collateral, within the loans comprised of the bond collateral.

THE COURT: C and S, right?

MR. SALTARELLI: That's correct, your Honor. You also as part of that case, your Honor, said again the fact that there were C-rated loans that may have been 60 percent of the bond collateral is not proof, will not prove the falsity of the market condition statements. Those are the statements, and there are a number of them alleged here, where defendants are alleged to have said and did say market conditions were the cause of the mounting losses and losses were being reported regularly throughout the entire class period in the bonds.

You ruled that the fact that they were C-rated loans within the bond collateral cannot and will not prove the falsity of those statements. There is only one way to prove the falsity of those statements. You have to find evidence that the bond collateral was comprised of facially defective loans and that you concealed that. That would make the market condition statements false or misleading because you concealed the fact that facially defective loans were causing the losses.

THE COURT: I think you glossed over the distinction,

indeed you don't mention any distinction, between falsity and misleading, which indeed the language is put in the disjunctive. And that is their new claim to fame here actually, a new sort of approach to this lawsuit. A little late in the game I might add. Nonetheless, it seems to me that what they are talking about really is more misleading.

Let us assume that you are right, that falsity is a little harder to prove. Misleading is probably not that hard or not as hard.

MR. SALTARELLI: Your Honor, I have no quarrel with misleading either. I think the question is very simple: Is there evidence of facially defective loans comprising the bond collateral? Facially defective loans, which you define in Dynex II as loans which were clearly fraudulent applications, no-release loans, and buy for loans. There has to be some evidence that the loans were actually those type of loans so that it would raise an issue of fact as to whether the statements about market conditions were arguably misleading, putting aside falsity, your Honor. That's where there is no evidence that the loans were those type of loans.

We produced all of these files to them, your Honor. In a footnote in their opposition brief, the only thing they raise in response to the facially defective loans -- by the way, I'll note their own expert, Dr. Ferry, admitted in his deposition he has not seen any facially defective loans. Not

aware of it, didn't analyze that at all. So he is not opining on facially defective loans at all.

The only evidence they put out in a footnote is a reference to a spreadsheet that was produced that refers to undisclosed buy for loans and a spreadsheet of the loans that went into default, just under 4 percent I believe of the defaulted loans for which a reason is stated. That is the only evidence that they have put forward.

THE COURT: They seem to say that 60 to 80 percent of the losses during the class period were caused by C and S loans. Admittedly, I didn't see any proof in their papers, but that is what they allege.

MR. SALTARELLI: Your Honor, that is specifically what you ruled in Dynex II would not prove the falsity of the market condition statements. The fact is, your Honor, there is no evidence of facially defective loans contributing to 60 or 70 percent of the losses or anything. The only evidence is what I have just referred to. They point to these buy for loans -- undisclosed to Dynex, by the way, that the applications were buy for type loans -- comprising at most 4 percent.

If you go back to Dynex II, your Honor, you were very clear. You sustained the allegation in the second amended complaint that these facially defective loans, inherent defects in these loans, caused 65 to 70 percent of the losses. That was your ruling in Dynex II, your Honor. There is no evidence

of that in this record, none.

THE COURT: That's what I just said.

MR. SALTARELLI: Your Honor, if there is no evidence of that --

THE COURT: We are going to let them tell us what their evidence is.

MR. SALTARELLI: I'm glad to hear it, your Honor.

THE COURT: They may balk, but that's what I said. So you don't have to tell me. I didn't see any support. I saw a different figure, 60 to 80, but it's close.

MR. SALTARELLI: I'll be glad to hear that, your Honor. But that is our position, that therefore there is no issue of fact as to the falsity of the market conditions statements. As I mentioned, Dr. Ferry was asked about this and has no evidence either that he raises about it.

THE COURT: We are still on market conditions, right? I am anyway.

MR. SALTARELLI: Sure.

THE COURT: Even if, as you say, your choice to stop financing was as a result of market conditions, how can you justify not disclosing your change in financing policy when you made statements that market conditions were causing the losses?

MR. SALTARELLI: Your Honor, there is an important distinction here.

THE COURT: We've got several.

MR. SALTARELLI: On the financing issue, your Honor. And this is their third alleged omission, which is also new to the case, it's a new theory.

THE COURT: I'm not arguing that.

MR. SALTARELLI: The financing of repossessed units, which is I believe what you are talking about, which is what they have characterized as an omission that made the market condition statements arguably false or misleading --

THE COURT: I think that's an unfair characterization. But you and I know what you mean, so go right ahead.

MR. SALTARELLI: The financing of these units, your Honor, was conducted by a subsidiary of Dynex. This was never undisclosed. It was Dynex Financial which originated these loans and sometimes financed them. That unit of Dynex was sold in 1999, and that was fully disclosed to the market. It was fully disclosed that Dynex was no longer in the origination and financing business, because it had sold DFI, Dynex Financial, to another company, which later became known or called Origin.

So there was no policy of financing repossessed units in 2001 or 2002 during the class period that was, quote-unquote, abandoned by Dynex. There is simply no factual basis to say that, your Honor.

That's their claim. They say that you abandoned that policy -- there was no policy -- and you didn't disclose that this lack of financing was causing the losses.

If you go to the evidence that they presented to raise an issue of fact about that, your Honor, it's one memorandum from an employee of Dynex named Bob Nielsen, I'm sure you have seen it, where he says quite clearly that he is relaying information that Origin, then an entirely separate company from Dynex, had told Dynex.

Origin, if you look at all of the memos that relate to this in their papers, was very clearly not interested in financing these repossessed units. No one was at the time, your Honor, because of the depressed market condition. They are saying to Dynex the reason for the losses or the main reason for the losses are the lack of financing.

So the question is, is there a disclosure obligation or is that something that makes the market condition statements false or misleading because you don't disclose that?

That fact, that there was a lack of financing for the repossessed units in this market, is absolutely part of the fact that market conditions in this industry were severe. One of the reasons why companies did not want to put out more money and finance repossessed units is because they were losing money and these homes were being sold in foreclose and the market was tanking. That is part and parcel. There is overwhelming evidence of that in these memoranda, in these reports by Standard & Poor's and Fitch and other analyses, your Honor. We have put them all forward in our brief.

So there was no obligation that did not make the market condition statements false, because those statements simply said the losses are being caused by market conditions. Well, market conditions encompasses a number of things. One of them was the lack of financing for repossessed units.

THE COURT: You don't think further identification was necessary?

MR. SALTARELLI: No, your Honor, not based on the evidence that that is part and parcel of market conditions. Even when some of the downgrade ratings and reports refer -- I'd like to talk about it a little bit briefly later. One of the documents they put in, as well as all those other independent market analyses, refers to the fact that as part and parcel of market conditions. So yes, your Honor, we don't believe doesn't raise an issue of fact as to the falsity or misleading nature of those statements.

Your Honor, let me talk about the modification data, your Honor. This is again a new theory. It's not in the second amended complaint, never addressed by you in Dynex II, and it appeared for the first time in this motion and in their contention interrogatories now.

The question there is similar, your Honor. They are saying, you had detailed modification data relating to loans that were modified and you omitted to put this into the monthly reports and you should have. The question becomes, as it does

in every omissions case: Is there a duty? does a duty arise? is there a duty to disclose that detailed data of how many loans were modified, the amounts, etc., in order to make some prior statement that was made not misleading?

They don't argue that there is such a prior statement that had to be made not misleading by disclosure. They say you had to put it into the monthly reports just to make them complete. Your Honor, they don't cite any independent duty to do that.

In the handout I have given you, under misrepresentations 2B, your Honor, B and C, these are parts of the prospectuses, and we have highlighted them, which disclose or set forth very specifically what information Dynex agreed to transmit to each bondholder, will transmit. That includes the things we listed in our brief, your Honor. It's the amount of the losses, collateral servicing fees, etc. There is no allegation that any of those reports or disclosures were false or misleading in any way.

At the next tab, your Honor, C, is the disclosure where we specifically say loans are subject to modification, they can be modified under certain conditions. It says that it may have an effect on the life of the class of bonds regarding prepayment, etc., your Honor.

The question really is, is there an obligation to disclose this level of detail about the modifications when you

have disclosed that the modifications can and will occur at the discretion of the servicer? Your Honor, we have cited cases -- and they haven't cited any cases that suggest there was except to one, which I will address -- we have cited cases that say when you have disclosed a general matter, such as overall liability, you don't have an obligation thereafter to disclose that level of detail. Those cases fit this.

The one case they have cited, your Honor, doesn't fit. That is the Caiola case. They say that's the case which makes your obligation to disclose your disclosures complete. But when you go and read that Caiola case, your Honor, it is very clear.

That was a case involving affirmative misrepresentations. Citibank was making disclosures about its hedging strategy that affected this plaintiff customer. The Second Circuit very specifically said, Citibank is alleged to have made affirmative misstatements about the nature of the hedging strategy, that's sufficient to state a claim. That is very, very different than what we have here, your Honor, in the modification situation.

I'd like to make one other point about it, your Honor. Of course, if you have other questions about these three. The case is now distilled to these three categories of alleged omissions.

THE COURT: I'd be glad to listen to anything else

you'd like to say.

MR. SALTARELLI: I'd like to talk a little bit about loss causation because I think it is a very, very significant issue. It is the first tab of the handout.

With respect to modifications and the other allegation about the lack of financing, there is no evidence, and even no attempt by Dr. Ferry, to connect for loss causation purposes those allegations to the downgrade announcement. I'm going to talk about that more broadly.

There has to be evidence or at least an attempt to connect the two things. They can't just leave hanging out in mid air allegations of falsity or omissions but then not connect them through evidence of loss causation to the downgrades of 2004 and the resulting drop in the price. That applies to all three of these matters, your Honor.

THE COURT: The problem really is whether, in my humble opinion, and I have to look at it all again, certainly will, my real problem is whether in each of these, which is why I was focusing on them, they don't present questions that are really jury questions and are not something I can decide on summary judgment. I think that is where we have our problem.

You have now done the best I think you could do to tell me there is nothing here that raises a material issue of fact. I just have to think about whether that is my view.

MR. SALTARELLI: I appreciate that, your Honor. That

is what we believe. It has to be a certain amount of evidence that makes it an issue of fact.

If I may briefly talk about loss causation. Loss causation is I believe a much more straightforward analysis. I will try to be brief. I want to talk for one moment about your loss causation ruling in Dynex II. Again, it is important because it has set the parameters for the case.

In Dynex II you ruled that there were the allegations of loss causation in the case that were adequate for pleading purposes. You characterized it this way. You said, well, they have alleged that there was this dramatic restatement of cumulative losses that initiated a downgrade review by Moody's that eventually led to the downgrades which caused the price drop, the price drop of the alleged damages. But that is factually not the case. The evidence is very clear now. That allegation in the SAC was wrong.

The review initiated by Moody's of a possible downgrade of series 13 bonds was issued on October 2nd. The restatement that occurred by Dynex took place on October 28th. Not before. It took place after. And a critically important difference, your Honor, it was not a restatement of cumulative losses, which would have been more significant, it was a correction, a restatement of cumulative repossessions.

There is no evidence in this case of a restatement or a correction of cumulative losses, and there is no evidence

that the downgrades were at all prompted, initiated, or stated in response to some restatement by Dynex. Dr. Ferry has acknowledged that. He doesn't argue that any of these restatements were corrective disclosures for purposes of loss causation, because he has found no price reaction in response to it.

I want to briefly talk about the law of loss causation. They have really grossly understated the standard for that articulated by the Second Circuit. That standard is when you allege a corrective disclosure which eventually leads to the price drop, it has to reveal a falsity of the misrepresentation, the representation, or the omission. It has to reveal this specifically with respect to the specific allegations made. It has to reveal hard facts. That is the standard set forth by the Second Circuit, your Honor. Actually, the circuit talks about but-for and cause in fact causation.

If you go to tabs Roman numeral IA through D, your Honor, these are what is alleged to be the corrective disclosures in this case. They are the four announcements, three by Moody's and one by Fitch, between February and May 2004.

If you go to tab 1, your Honor, we have highlighted the language here, the only language, that talks specifically about the Merit bonds other than pure factual information at

the bottom. You can see here that Moody's is saying the rating actions are prompted by weaker than anticipated performance. It does not make any specific reference or reference to any of the specific allegations of misstatements or omissions that are actionable. Facially defective loans, not mentioned. Modification data not disclosed, not mentioned. The lack of financing making the market condition statements false, not mentioned, your Honor.

In fact, if it mentions anything, in the second sentence it says overall performance in the manufactured housing sector has been weak in the last few years. That is entirely consistent with what the market statement said, your Honor. So you have both the lack of any connection to the specific allegations of falsity or misleading or omission and corroboration of the market condition statements themselves.

That is the same, your Honor, in A, B, and C. One of them doesn't mention the market, the other one does. Those are the Moody's statements.

Now I'd like to talk briefly about the Fitch statements. It's interesting. They have characterized the Moody's statements as quintessential corrective disclosures because they specifically reference the subject matter of the omissions. As I have just said, your Honor, I don't think that any reading of the language of actual announcements can possibly satisfy even that standard, which is not the correct

standard in any event.

Let's talk about the Fitch statement for a second, your Honor, which is tab D. This is the one where their argument is, oh, this referred to relaxed credit standards and that's what we are talking about. But when you read the sentence after it, and if you look at Fitch, actually, one of series, one of the classes, the charges was not downgraded at all by Fitch. Class A3 was affirmed at AAA. That suggests quite a bit about the so-called poor credit quality of the collateral.

In any event, the sentence that we have highlighted, if you read it, again, any fair reading of this language, your Honor, does not make any reference, any reference at all, to the specific allegations of fraud made by the plaintiff in this case. The first sentence talks about the industry has experienced worst down-turn. That's what we said. Relaxed credit standards, overbuilding, difficulty servicing have all contributed to poor performance of MH securities, your Honor. That is not a reference to the Merit bonds. It's a reference to this entire industry and all of the securities.

The last sentence is again a reference to the industry in general, your Honor.

I'd like to make just two other points if I can. There is another document they have tried to now allege is a corrective disclosure. If you would like me to discuss it, it

is not listed in their responses to their contention interrogatories which binds them, it is not listed in the SAC, in the second amended complaint as a corrective disclosure. It's a newswire. It's in their documents. There is nothing in there as well. That document, which is a press release and some interviews, doesn't disclose anything specific. It suffers from the same exact defects as the others.

Let me make two other quick points, your Honor. In order to make this connection between these documents and the purported loss following the downgrade, Dr. Ferry puts in his expert report. That's their evidence of this connection. But Dr. Ferry makes no attempt to link the corrective disclosures or to identify any specific allegations of fraud in the corrective disclosure.

In fact, he admitted in his deposition: I don't even know what they are, I haven't analyzed them, I haven't studied them. All he said, without even identified the statements, is Dynex must have said something about the quality of these loans because later the magnitude of the downgrade was so severe.

What he doesn't say, your Honor, he doesn't make any reference to the facially defective loans. He says he has no knowledge of them, again doesn't identify any statements about quality that he is referring to. And he doesn't link or make any reference to the actual specific statements.

It gets worse with respect to the last point about the

downgrade, your Honor. Dr. Ferry said one of the main reasons I am sure this is a corrective disclosure is because the magnitude of the downgrades nine, ten notches was so rare and unusual, there must have been something wrong that Moody's and Fitch were reacting to.

But now there is undisputed evidence, your Honor, and I believe we have noted that. If you look at tabs F and G, F is a chart which lays out on the left-hand side the statements by Dr. Ferry, their expert. This is their evidence of loss causation. On the right-hand side, your Honor, is evidence which is undisputed by the plaintiff. That is set forth in tab G in their 56.1 statement of the average magnitude of downgrades for manufactured housing sector bonds during the class period.

If you look at the chart, your Honor, the Merit bond securities fall right in the average. They are not rare or unusual at all. And there were hundreds of these downgrades. Before Fitch even downgraded the Merit bonds, it had issued 1340 downgrades of MH type securities just like the Merit bonds, your Honor.

Your Honor, if you have any other questions. I do believe that those are undisputed facts with respect to the other downgrades. As a matter of law, your Honor, these corrective disclosures -- it is their allegation of corrective disclosures, your Honor.

They don't even attempt or purport to disclose the specific allegations of the falsity that is alleged by the plaintiff. Those are not my words, your Honor. Those are the words of the Second Circuit in Omnicom. That is the requirement. They don't purport to disclose or correct the specific statements of fraud. There is no hard facts at all disclosed in these documents as a matter of law. That's why I said it was a more straightforward issue, your Honor: As a matter of law they cannot be corrective disclosures.

THE COURT: I think I have your drift.

MR. SALTARELLI: We have cited a number of cases on corrective for the standard. It is not surprising, they have cited no case that supports their standard about specifically reference the subject matter of. That is not the standard. It has to specifically reference and reveal the falsity. That's the standard.

Unless you have any other questions, your Honor.

THE COURT: No. I think you have done well in terms of my concerns, or most of them.

MR. SALTARELLI: Thank you.

THE COURT: Why don't you start and see what you can tell me about Mr. Saltarelli's argument with respect to loss causation.

MR. LAITMAN: Your Honor, may I hand this up, please? This is a handout.

THE COURT: Sure. Whatever it is, you can hand it up. Do you want to give us a hint, Mr. Laitman?

MR. LAITMAN: Yes. I just wanted to make sure defense counsel had a copy.

THE COURT: You could have given it to him before the argument, then you'd be sure.

MR. LAITMAN: Your Honor, in terms of loss causation, Mr. Saltarelli ran on and on about a corrective disclosure. The reality is under the Second Circuit law there are two ways to demonstrate loss causation. One is a corrective disclosure and the other is a materialization of the concealed risk.

If you wouldn't mind, your Honor, looking at the chart I handed out, on the top in yellow are many of the statements cited in the amended complaint. Basically, the statements boil down to three categories, as your Honor knows. The first is that the cause of the bond losses were market conditions. 2 is that there were ever-expanding loan loss reserves required. The third is about internal controls, the adequacy of internal controls.

On the bottom, below the red, are the three concealed schemes. One is at every point in the class period. At every point when defendants made their statements that the losses were due to generalized market conditions, they had specific knowledge that 60 to 80 percent of the defaulted loans were those C and S loans that were known from the outset to be of

the worst credit quality.

THE COURT: I mentioned that earlier. I wonder if you could tell me how you reached the 60 to 80 percent of the losses during the class period having been caused by C and S loans.

MR. LAITMAN: They rated every loan.

THE COURT: "They" being Dynex?

MR. LAITMAN: Dynex. When they originated it, they rated every loan according to this standard. If you look at Exhibit B, that is the key to what A, B, C, and S means.

THE COURT: I'm looking at B. Of course, it's upside down. Maybe it's me that's upside down. Here we are.

MR. LAITMAN: That's A, B, C. Most of the loans that were defaulted in the C and S category were C. There is no dispute those loans had the highest debt-to-income ratio, required the least borrower employment, and tolerated the most problems or deficiencies on the credit history.

All you had to do -- and this was no secret. We make this point in our memorandum of law. In many presentations -- and it is not just related to pricing. Defendants tried to say this was a pricing. It wasn't just a pricing. They were constantly looking at the quality of their loans. Everyone knew, including Mr. Potts in his deposition, that at least 60 percent of the loans were C loans. It's never mentioned in the offering documents.

When they say during the class period the losses are due to the market conditions, they know that the C and S loans are driving the losses. Now, at the pleading stage, your Honor, we couldn't present that evidence. We didn't know that they tracked every loan. But it's obvious in their documents and it is not disputed. At every point in the class period, they knew that, a predominant fact, 60 to 80 percent of the defaulting loans were these poor quality loans that were known from the outset.

As your Honor said at the beginning, this is a motion for summary judgment. Defendants argue there is no issue of fact that a reasonable investor in the class period would have wanted to know before he bought the bonds in the class period that it wasn't just market conditions but 60 to 80 percent of the defaults were due to poor quality loans from the get-go?

THE COURT: I think the defendant is saying that it was all part and parcel of market conditions and that's what Fitch -- well, I don't know. All of these in his handout sort of indicate, as do all the briefs, Moody's and Fitch, about how terrible this market was. He is saying this was part of the landscape.

MR. LAITMAN: Let's go to Exhibit F. Exhibit F --

THE COURT: I assume you mean your Exhibit F.

MR. LAITMAN: My Exhibit F, yes. This is an article where Moody's was interviewed specifically --

THE COURT: Where does it come from?

MR. LAITMAN: This comes from the Dow Jones newswire.

THE COURT: It's not part of what you provided, at least I don't remember seeing it.

MR. LAITMAN: It's in the summary judgment papers, your Honor. We quote from it extensively in the summary judgment papers.

THE COURT: I guess I take that back. OK.

MR. LAITMAN: What do they say here? Mr. Saltarelli said this article proves their point that it is just market conditions. Nothing could be further from the truth. Take a look at the second page of the document. At the middle page it says, "But in the Merit case Moody's cited weaker than anticipated performance for ratings cuts."

Before we go on, let's be very clear. This whole issue of loss causation was already dealt with by Dr. Ferry. He did event studies which looked at the drop in the price of these bonds on the rating downgrade dates and factored out what was happening to the index, the manufactured housing index.

The reason these were material events and the reason your Honor found that there was a causation sufficient to certify the class was because we factored out market conditions. Whatever Fitch and Moody's said, and we are going to come to this article in a second, but whatever Fitch said about generalized market conditions, they were now applying it

to these bonds.

THE COURT: He says Dr. Ferry said essentially there must have been something wrong but that he was unable to put his finger on anything.

MR. LAITMAN: He is not the liability expert.

THE COURT: But he reviewed all these pieces of paper, I presume.

MR. LAITMAN: Right. But what he did do as part of his events study is he said, let me look at the manufactured housing index. If it's true that it's market conditions, there shouldn't be a reaction on the day that Moody's downgrades these bonds. There shouldn't. The entire market should go down. That's what market conditions means. Lo and behold, that didn't happen. You had a dramatic collapse just on the Merit bonds.

Let's look at exactly what is said in the middle of the page. In the Merit case Moody's cited weaker than anticipated performance for ratings cuts. How does something that is monitored monthly deteriorate that fast? Here we go. "Denise Pearson, a senior credit officer in Moody's manufactured housing group, said Merit's situation is unusual. Not only has the quality of the pool of assets backing the deal deteriorated more than anyone had anticipated, but the monthly reporting on the transaction has been difficult to interpret at least partially because the company was coping with issues in

its reporting system. 'The data might show a zero percent annualized repossession in one month and a 70 percent rate in the next month.'"

Before Mr. Saltarelli sat down, one of the last things he said, your Honor, is that there is no evidence that the improper reporting of repossessions was the reason Moody's downgraded the Merit bonds. Here you have a specific quote from the senior person at Moody's saying, you know what, Merit isn't like the rest, we didn't downgrade this for the same reason we downgraded all the other bonds, we downgraded it because Merit was unusual, their financial reporting of the transaction can no longer be relied upon.

That brings us directly to the nondisclosure of the previously defaulted loans or modified loans that is the second scheme in this case. Let me be very, very clear about this, your Honor. If you go back to the front chart, the yellow statements, every one of these yellow statements, we already said that one was the problems are only market condition. The second statement in that yellow at virtually every point in the class period is a statement about the loan loss provision.

One of the things Mr. Saltarelli said was plaintiffs, they said in the papers, abandoned the loan loss provision allegations as false, that we don't allege that there was anything false stated and that only an affirmative duty to disclose. Again, nothing could be further from the truth.

Let's understand exactly what happened in discovery. If you go back to the complaint, on paragraph 81 of the complaint we have a heading. The heading is very clear. The heading says, "Dynex and Merit officers Potts and Benedetti repeatedly assessed and learned the impaired quality of the bond collateral as a result of the monthly reports and the Merit quarterly and annual filings."

What did we do? We subpoenaed Mr. Benedetti's loan loss analysis to see what did Mr. Benedetti know at each point that he did the loan loss provision. What we learned was astounding. That's why we now have modifications in this case. If you turn to Exhibit D, this is what Mr. Benedetti knew when he did his loan loss calculations. This is why the loan loss calculations are rendered blatantly false by the nondisclosure of the modification.

In the black column, in the black column, every month Dynex put on its website current loans, 30, 60, 90, foreclosure repo loans. Bondholders only saw what was in black; Mr. Benedetti knew what was in red.

Just consider the first line. That's all you have to do. The very first line says, current loans. This is for June. We are taking June 2003, but he did this for many other quarters. The current loans are 228 million. So the average investor goes to the Dynex website, how many current loans are there, what is the dollar amount, 228. What doesn't he know?

He doesn't know that 31 million of that amount are loans that have already defaulted once.

More than that, Mr. Benedetti did another calculation. He said, how much more likely are those 31 million likely to default than a regular current loan? What does he come up with? 387 percent more likely.

Let's go back to what is the standard on summary judgment. Would an investor want to know, when he read the monthly report, when he looked at the loan loss reserve calculation, that the reason Mr. Benedetti keeps hiking the loan loss reserve is that there is undisclosed previously defaulted loans that have a 300 percent greater likelihood of defaulting again.

This is the most important, this is the most important fact that an investor could possibly want to know. He wants to know are the current loans really current or are they filled with a material portion of loans that have already defaulted once?

It gets even worse when you go through the other categories. 60 percent of what bondholders were told as 30-plus, 60 percent of those loans had previously defaulted. 80 percent of 60-plus had previously defaulted. Now let's go back to the loss causation. What is the materialization of the risk? The materialization of the risk is another prong.

By the way, the standard is not to resolve the chain

of loss causation on summary judgment, but what did the concealed risk materialize in the rating downgrades. The rating downgrades, it is undisputed, were due to greater than anticipated defaults and losses. Well, if you're not telling the bondholders that in every category of loans there is a fifth column of previously defaulted loans, what is the materialization of that nondisclosure? The materialization is more than anticipated defaults.

THE COURT: Didn't Dynex already disclose the loan prices which provided information essentially regarding the quality of the loans?

MR. LAITMAN: No, nothing. That is an excellent point, your Honor. Go back to the very first page, the chart. Before the beginning of the class period, we have the statements in the prospectus. If you go to Exhibit A, I copied all of the data, the detailed data, that investors are told about these loans. Very interesting.

They are told about unpaid principal balance. They are told about loan-to-value ratio. They are told about current interest. They are told about the state where the loan was generated. It is pretty much identical in both the M12 and M13, very, very detailed information.

What is not there? Any information about borrower creditworthiness. No debt-to-income ratio. No employment history requirement. No credit history requirement. Why?

Because had they disclosed that information, had they disclosed that information, it would be readily apparent that 60 percent, 50 to 60 percent of the collateral had the worst quality of debt-to-income, the worst employment history requirement, the worst credit history requirement.

That's why in the chart, if you look, I list all of the information they did put in the prospectus, and look what they happened to omit. They happened to omit anything that would give the investor any inkling about the true extent of the poor creditworthiness.

Again, your Honor, when you wrote your decision on Dynex II on the motion to dismiss, we didn't have the data of what A, B, and C meant. We didn't know that A, B, and C meant something specific about debt-to-income, credit history, employment history. Now we do. Just like now we know precisely at each point when they said the loss was due to market conditions, in fact now we know that the driver of the losses were the loans that were known from day one to be the worst credit quality.

THE COURT: It's interesting to me, and maybe you can help me. Since you didn't have some of this information at the time that I wrote Dynex II, and the theory was really falsity, and you're just telling me why it was even better afterwards, why are we now talking in your new theory about misleading rather than false? You don't really have to answer that, but

it certainly is interesting.

MR. LAITMAN: It's very straightforward, your Honor. The green fraud --

THE COURT: The green fraud?

MR. LAITMAN: The green fraud in the chart is that at each point in the class period defendants knew that the driving cause of losses wasn't generalized market conditions but the poor quality loans. That's directly from the complaint. That hasn't changed.

The only thing that's changed, that has become more detailed, your Honor, is that now we know it wasn't just generally they knew during the class period that they had these bad loans. They knew precisely at each moment in the class period. That's what we know now.

THE COURT: Doesn't that go more to falsity than to misleading? Again, that's a frolic and a detour.

MR. LAITMAN: Let me explain what happened. The modification, when we say modification, it's concealing previously defaulted loans. We did not have Mr. Benedetti's work papers, obviously, prior to discovery. Those modifications proved the falsity of every loan loss provision.

Why? What did Mr. Benedetti say to investors? He goes, we are having to increase the loan loss provision because of market factors and increase in defaults. He is not telling them that they are having to increase because of the fact that

there are all these previously undisclosed defaults that investors aren't told about.

The amazing thing to me is the way that Mr. Saltarelli tries to get around this huge nondisclosure of such a critically important thing is to say, well, we didn't have to put it in the monthly report. The prospectus says -- this is one of the most blatant --

THE COURT: This is not a summation.

MR. LAITMAN: No, no. The prospectus says Dynex had to provide on an ongoing basis all current information regarding modifications. It says it, black and white. We quote it in our opposition brief. Why didn't they provide it? Unbelievable: Nobody asked for it. Nobody asked for it.

If somebody would have called, this is what Mr. Benedetti said --

THE COURT: I read it.

MR. LAITMAN: If somebody would have called me and asked me, I would have told them, by the way, 60 percent of the 30-day delinquent are previously defaulted loans. It just can't be. The federal securities laws aren't designed so that the investor has to call up and ask questions.

You asked why did we have the modifications in the initial complaint. Because we didn't have Mr. Benedetti's work papers on the loan loss provisions. As soon as we got them and analyzed them and deposed him, we now have it in the documents.

Every one of the loan loss provisions statements are now fortified by the nondisclosure of the previously defaulted loans that they were obligated to disclose by any fair reading. At the very least, it's an issue of fact.

THE COURT: You make another point with respect to what contributed to the losses. You indicate that that is that they stopped providing financing on the repossessed units. Do you have any evidence that I must have missed to support that that policy caused any or contributed to the losses?

MR. LAITMAN: Yes. Mr. Nielsen is one of the people that reported to Mr. Benedetti, and he states, and this is Exhibit F, his memo -- I'm sorry -- Exhibit E.

THE COURT: This is his hearsay statement?

MR. LAITMAN: For purposes of summary judgment.

THE COURT: It's not a fault, counsel. I just want to be sure we are talking about the same thing.

MR. LAITMAN: What I wanted to add is we deposed Mr. Nielsen and we have his testimony. I'd like to read it to you. One of the defenses that Mr. Saltarelli said is this wasn't my policy, Dynex, this was a policy after we sold the company.

First of all, we are playing games with semantics here. DSI was Dynex Servicing, Inc. This memo says, "Largest issue affecting losses per DSI," Dynex Servicing, Inc., "is that we" -- Mr. Nielsen is writing this, he is a representative of Dynex -- "that we are no longer financing our

repossessions."

Mr. Saltarelli's point is that had to do with somebody else, we already sold the company. Throughout the entire class period, Dynex was the master servicer.

THE COURT: When did they sell to Origin or whoever?

MR. LAITMAN: They did sell to them. But the reality was the policy before the class period was mobile home was repossessed, manufactured home was repossessed. Servicer said we'd take it. Somebody would come and say, I'm interested in buying it, what kind of financing could you provide me? The servicer or the master servicer, whether it was Dynex, whether it was Origin, would say we'll provide you financing, these are the terms.

What happened in the class period that was dramatically different is they repossessed the mobile home.

THE COURT: I know what happened. What he is saying is that Dynex had nothing to do with this. You're telling me that that's smoke and mirrors.

MR. LAITMAN: Because they are the master servicer and origin is the servicer. What always had been the prior practice, the way they resold these things was to provide financing. All they are saying in the public statements is the losses are due to market conditions and the big lenders have left. They are not saying the much more powerful critical point, that the servicer is no longer providing financing.

That is, the entity that actually takes possession and tries to resell isn't providing any financing to allow the resale.

They say, well, we disclosed that when we said major lenders have left the industry. You're missing the forest for the trees. The major lenders leaving is not the critical piece to the Merit or Dynex mobile homes that are repossessed. It's whether or not the servicer that takes possession of those has a means to resell them.

THE COURT: I don't see where you're telling me how it contributed to the losses.

MR. LAITMAN: What does Mr. Nielsen say? He says, "Largest issue affecting losses per DSI," Dynex Servicing, Inc. By the way, this email is 2001, in the class period. We are no longer financing. That's it. This alone creates an issue of fact. They are saying it's due to some generalized departure of lenders. Their own internal email by the guy who is closest says the losses are due to our policy changing, not the general policy.

But what does Mr. Nielsen say in his deposition? Their defense is Mr. Nielsen wasn't saying what he thinks, he was saying the policy of Dynex Services, Inc., and that's not ours. This is his testimony. We asked him what that phrase meant. He says, "Because Dynex Capital is not providing financing, dealers were more reluctant to sell units for Dynex Capital." We asked, "Was that your opinion?" "Yeah, that was

my opinion." This is page 88 of the Nielsen deposition.

Their defense in their reply brief is this wasn't Mr. Nielsen's opinion, it was somebody else's. The deposition testimony specifically says, this was my opinion.

"What do you mean when you say largest issue, largest issue affecting losses per DSI? Is that we are no longer financing?"

"That means we are having to wholesale more units than we are able to retail, and in the context a wholesale generally recovers less than retail. So this generally would increase losses."

Again, Mr. Nielsen isn't saying this is somebody else. As master servicer, he is saying this is us, and he is directly tying it to the losses. This is page 136 to 137.

THE COURT: Let me ask you another question. I guess it goes to most, or some at least, of these concerns. Where is the line between the obligation to spell out or disclose versus an invitation to ask and be told? Do you understand the question?

MR. LAITMAN: Yes. I think, your Honor, the line is when Dynex started to say things affirmatively. I agree had Dynex been silent about the causes for their losses, had Dynex said nothing about their loan loss reserve increasing due to these manufactured homes, we wouldn't be here today.

But the reality is they affirmatively said to the

market repeatedly, we're having increased losses due to these manufactured homes, never disclosed the previously defaulted loans that are driving the loan losses. They said the losses are due to market conditions affirmatively, never disclosing that in fact it was the change in their own policy and the servicer policy that was driving, that was in fact the largest issue according to their guy. And they said it was due to market factors even though they knew it was the worst quality loans to begin with.

When a company goes out of its way, opens the door, as your Honor said in Dynex II, once they went down the road of giving affirmative reasons for losses, once they went down the road of talking about increases in their loan loss provision, they've got to be fully truthful about what those causes are. The reality is the causes that they concealed, there is a reason why they concealed it: Because it was what they did from the outset. They didn't want to tell investors we have all of these defaulting loans that we have had to modify.

If your Honor would take a look at Exhibit C. When was this offering? M13 was in September 1999. By the way, the extension information is incomplete. But here you have extensions on the M13 and the M12 loans virtually every single month in 2000.

For the first eight months you have you've got almost 25 million in previously defaulted loans that were never

disclosed in the first seven or eight months of this deal. We know now from Mr. Benedetti's own notes that by the time you get to June 2003, you've got 80 million, slightly more than 80 million, in previously defaulted loans that they are putting in as current.

The argument on scienter is we didn't have to disclose the loan rating system, we didn't have to disclose modifications. Well, here again it's the same line. When you come out and are affirmatively providing investors either loan loss information or monthly delinquency information and current loan information, you can't hold back such critical information. Certainly these raise issues of fact.

Again, we are not finding the previously defaulted loans in the files of some minor employee in some district office somewhere. We're finding them in Mr. Benedetti's own files.

THE COURT: All right. I think I got it.

MR. SALTARELLI: Your Honor, if I may have just a moment?

THE COURT: You may have two moments.

MR. SALTARELLI: Thank you. I won't beat a dead horse, your Honor, but I find it very telling that Mr. Laitman made no attempt whatsoever to talk about the four corrective disclosures in the case, the Moody's announcement, no effort whatsoever, your Honor. He shifted immediately to what he

calls the materialization of the risk theory, which is an alternative theory.

Your Honor, their argument on this theory is contained in one paragraph of their brief. They say the loss is materialized in February and March of 2004, led to the downgrades. That is completely false. The losses were recorded from 1999 to 2004, every month the mounting losses. They did not materialize in February and March 2004.

The risk of these losses due to increasing delinquencies, your Honor, was expressly disclosed in the prospectus. We have cited this in our reply memorandum. Under the Second Circuit case in Lentell and others, your Honor, that means you can't prove loss causation if you have disclosed the actual risk of loss that you claim is materialized. That same case says even though have a corrective disclosures, you still have to draw a line between the misrepresentation and the loss.

Your Honor, I'd like to talk for a minute about the modification issue. He shows you the chart, which we have seen before. I'd like to refer you to tab 2C, your Honor, if I may. There are two pages to this. These disclosures in the prospectuses, your Honor, specifically disclose that loans that are defaulting or have defaulted or are in default without being foreclosed are subject to modification.

THE COURT: I heard that from you and I read it myself, believe it or not.

MR. SALTARELLI: The point is simply that it is disclosed, your Honor. The question is, do you have to disclose the nitty-gritty when you are disclosing 30, 60, 90 days?

THE COURT: That's a big issue.

MR. SALTARELLI: I didn't hear any evidence. You asked the appropriate question, what is the evidence that these C-rated loans were the cause of the losses? If you look at tab A of part 2 on the handout, that shows you this whole point about the poor credit quality is a sham, your Honor.

The loans that were approved and underwritten were in the top 31 percent of all the loan applications that were made. This argument amounts to nothing more than whenever you rank something, if you're ranking colleges, law schools, whatever, you're going to say there are some in the bottom half of the rank. That's really all this amounts to, your Honor.

The key point of it is there is no evidence, and this is the allegation you sustained, as to facially defective loans causing the delinquencies. You said it in Dynex II. Is there proof that 65 to 70 percent of the delinquencies was caused by facially defective loans? No evidence of that. Didn't hear that from Mr. Laitman.

Your Honor, the Dow Jones newswire, they have alleged or tried to say that is corrective disclosure. It's a bit late in the game for that, as I've talked about before. I'm not

afraid of that document. I have actually included that as part of our package. It's Exhibit E tab 1. Obviously, as you noted, this is a news article which is quoting people. It's rank hearsay. But if you read this, there is nothing in here that talks about fraud from Dynex.

The first page, the bottom of it I have highlighted, says investors say the Merit downgrade is severe but they have become used to such dramatic moves when it comes to manufactured housing. The top of the next page says the same thing, your Honor.

THE COURT: It goes on to say that the Merit case is a little different.

MR. SALTARELLI: Yes. But let's look at that language, your Honor. What they actually say, if you read this, it quotes an analyst, not from Moody's, who says sometimes these performances are due to fraud and servicing problems. But that's not what Moody's said with respect to the Merit bonds. It actually says fraud wasn't an issue with the Merit bonds, it was the data.

What did they say about the data, your Honor? The only reference in this document to a data issue with respect to Merit has to do with the repossession correction. It specifically talks about repossession. This document cannot be a corrective disclosure, because Merit corrected the repossession issue in October and there was no price reaction

to it

So this document is not a revelation of any mysterious concealment about repossession data. It refers to something that was disclosed six months, seven months earlier.

THE COURT: I don't really need to belabor this any further. It has become a career already.

MR. SALTARELLI: I do want to point out, your Honor, you made a reference, and it is true. We have cited in our reply brief the breakdown of interest rates applicable to the loan which was a proxy for those categories is set forth in the prospectuses. You're correct about that, your Honor.

Unless you have any other questions, your Honor, I appreciate the time. Thank you.

THE COURT: I will reserve decision. I thank you all for being able to jockey around my questions throughout your argument. We will be in touch.

When do we try this case if summary judgment is for some reason denied? November?

MR. LAITMAN: November 16th, your Honor.

THE COURT: We'll get to this quickly one way or another.

(Adjourned)